FAST FORWARD:

Accelerating Canada's Leadership in the Internet Economy

SUBMISSION TO HOUSE OF COMMONS STANDING COMMITTEE ON FINANCE

FROM

CAPITAL MARKETS TEAM
CANADIAN E-BUSINESS OPPORTUNITIES ROUNDTABLE

September 15, 2000

INTRODUCTION

The Capital Markets Team, a sub-group of the Canadian e-Business Opportunities Roundtable ("Roundtable"), is submitting this brief. The Roundtable was initiated by The Boston Consulting Group (Canada) ("BCG"), and supported by the Federal Government and other companies, in mid-1999 to develop a strategy for accelerating Canada's participation in the Internet economy. Its goal was to establish Canada as a globally recognized, e-Business leader and to promote a higher quality of life for our citizens through economic growth, job creation and more convenient access to information, goods and services. The Roundtable has been a voluntary, private sector-led initiative consisting of 30 leaders from the Internet, finance, academic and Government sectors. A complete list of the Roundtable members is attached as Exhibit A.

The work of the Roundtable led to the publication in January, 2000 of a comprehensive report titled *"Fast Forward: Accelerating Canada's Leadership in the Internet Economy"*. This report is incorporated by reference in this Brief as it provides much of the background to the recommendations contained herein. A copy of *Fast Forward* has been attached as Exhibit B.

Since the report was published, a number of sub-groups or teams, including the Capital Markets Team, have been formed to continue the work of the Roundtable. The Capital Markets Team was formed to specifically address the tax and market infrastructure issues affecting the establishment and growth of the entrepreneurial sector in Canada. The members of the team consist largely of senior venture capital financiers and technology industry executives who understand well the challenges of early stage financing, the issues affecting the growth of technology companies, and the issues affecting capital formation and investment liquidity. A list of the Capital Markets Team members is attached as Exhibit C.

Although the rallying cry for reform of the capital markets and, specifically, tax reform is the furtherance of the Internet and new technology economy, the Capital Markets Team believes

the proposals set out below will benefit all industries. For this reason, we are not advocating special treatment for the technology sector but rather broad based reform for the benefit of all industries in Canada.

The information technology industry is responsible for a significant portion of new jobs in Canada and growth is expected to continue to be strong over the next decade. The recommendations set out below will directly benefit the estimated 10,000 technology businesses present in Canada today. These benefits will, in turn, have powerful positive spillover effects for the traditional employment sectors including transportation, retail, construction and various service providers.

We believe the changes below represent an investment in the future of Canada which will very quickly pay off through significant job growth and higher levels of income for all Canadians regardless of industry or individual skill levels.

OBJECTIVES

The objectives of the Capital Markets Team are an extension of those set out in the *Fast Forward* report and are as follows:

- To establish Canada as a leader in the development of world-class technology.
- To develop the world's largest pool of venture capital and the largest number of successful new companies as a percentage of GDP.
- To establish Canada's reputation internationally as a country seriously committed to attracting foreign investment capital over the long term.
- To address the brain drain of our best and brightest people migrating to the U.S. by creating an economic environment to convince engineers and scientists, entrepreneurs and investors that they can generate significant personal wealth without leaving Canada.
- To increase the level of job creation and disposable income for all Canadians, regardless of industry or geographic location.

GUIDING PRINCIPLES

The Capital Markets Team is guided by a number of core principles in making these recommendations, including the following:

- The rapid pace of development and change in the e-Business economy demands quick and comprehensive change to the Canadian business environment. Today's entrepreneurs, backed by high-risk venture capital, are creating tomorrow's corporate giants in the technology industry. Canadians will only become leaders in this emerging new economy to the extent that engineers and scientists, entrepreneurs and investors can be persuaded to contribute more of their time, energy and capital. Small incremental policy changes are barely noticed by the key economic players in this sector, and will therefore be generally ineffective. Bold action is required if Canada is

to secure its standing in the global first division of the 21st Century economy. Economic policy must be designed to encourage Canadian entrepreneurs and investors to undertake these activities as effectively as possible.

- Many of the best and brightest Canadians will naturally move to where their economic opportunities are greatest. Canada is well positioned to be a leader in the Internet economy, given its sophisticated infrastructure, highly educated citizens, and well connected population. Nevertheless, we continue to see many of our most talented entrepreneurs taking their ideas, energy and businesses to the more dynamic and welcoming markets in the U.S., where the financial rewards for their efforts are better matched by the substantial risks taken. This is particularly apparent in the digital economy where valuable intellectual property assets, know-how and energy depart alongside every educated experienced professional crossing the border. With the right economic policies, most of these emigrants can be persuaded to remain in (or return to) Canada.

- Much literature exists extolling the virtues and performance of the Canadian economy relative to the G-7, the OECD nations, or other countries around the world. While many of these reports are true, they are largely irrelevant. We believe that the United States is the only country to which Canadian tax and economic policy comparisons are relevant. The U.S. is Canada's only significant competitor for investment capital and human resources – the two key inputs for Canada's future success in the knowledge-based economy. Policymakers can demonstrate their commitment to the new economy only by creating a fiscal and regulatory environment that approaches or exceeds conditions in the U.S. Tax and other policy changes will not have a significant impact on the North American competitive landscape if they are too small to be noticed in the U.S., even if they are large by historical Canadian political standards.

- Members of the Capital Markets Team and the Roundtable have had numerous discussions with U.S. and international investors. The basic view of Canada as a place to invest money in technology opportunities, and indeed any industry outside the natural resource sector, is not very encouraging. The common view is that Canada is, at best, a distant second to the U.S. in the level of taxation and overall attractiveness, and generally well behind much smaller countries such as Israel, Sweden and even Ireland. This view is entrenched in the minds of the international community and will be difficult to change. Canada can dramatically alter the opinion of foreign investors only through significant and dramatic improvements to its financial and tax systems. If Government strategy is based instead on a series of small, incremental improvements, Canadian entrepreneurs will remain largely unnoticed by the foreign investment community.

SPECIFIC RECOMMENDATIONS

Capital Gains Taxation

Capital gains taxes are an important factor in providing wealth for entrepreneurs and for encouraging individuals to invest in high-risk ventures, particularly knowledge-based companies. The dramatically higher capital gains tax in Canada lies at the core of the "brain drain" of entrepreneurial and technically skilled personnel to the U.S. These individuals create new and innovative products and services and are keenly motivated by the possibility of reaping extraordinary gains when their companies go public or are acquired by larger firms.

On February 27, 2000, the Federal Government reduced the capital gains inclusion rate from 75% to 66 2/3% for capital gains received after February 27, 2000. Although this was a step in the right direction, the Capital Markets Team believes the decrease to be insufficient as it still compares poorly with the U.S. and many other countries competing for financial and entrepreneurial investment.

Canada must provide a competitive after-tax reward for successful investment. We recommend that Canada adopt a capital gains tax system, which rewards successful entrepreneurs and their investors with competitive after-tax returns. Specifically, we suggest a reduced capital gains tax rate that declines based on the length of time which the investment is held. The U.S. system is based on capital gains tax of only 20% for investments held longer than 12 months. The United Kingdom has adopted a similar approach that scales down the level of capital gains tax to 10% for assets held longer than five years. In Canada, a capital gains tax based on an inclusion rate of 30% for assets held longer than one year would result in a capital gains tax level which is more competitive than the U.S.

Interestingly, historical evidence from the U.S indicates that, in years in which capital gains tax was reduced, the overall level of tax revenue increased dramatically, indicating that reductions in capital gains rates will unlock tax revenues. This occurred in the years following all three years in which rates were cut – 1978, 1981 and again in 1996.

Deferral of Capital Gains upon Reinvestment

The February 27, 2000 budget provided some ability to defer capital gains tax on the disposition of shares in certain small businesses provided the proceeds are reinvested in other small businesses. Specific terms limit the deferral to a maximum of $500,000 of eligible investments (Canadian-controlled Private Corporations or "CCPCs"). However, this rollover is restricted to individuals only, and, the total carrying value of the assets of the corporation and related corporations is not allowed to be greater than $2.5 million, before the investment, and no more than $10 million, post the investment. Although many individual investors welcomed this change, the legislation does not go nearly far enough in providing a meaningful incentive nor does it take into account certain realities of early stage technology investing.

Compare this legislation to the U.S. environment where an eligible business is defined, in part, as having assets equal to or less than US$50 million before and immediately after the

initial investment is made. The equity in question can be received through treasury purchase or through an employee stock option plan ("ESOP"). Once an investment is made, there is no limit to how large the company can become, nor on the dollar amount or the number of times that the investment proceeds can be rolled over. Capital gains tax is deferred so long as the investment is held for more than six months and reinvestment of proceeds takes place within 60 days of any disposition. In addition, rollovers in the U.S., once restricted only to individuals, are now available to eligible investments held by individuals through partnerships.

The difference is clear: U.S. tax policy is designed to encourage reinvestment by professional investors managing the largest institutional investment funds, while Canada's incremental measure provides much more limited relief, and only to small, primarily non-professional, investors. If Canada wants to promote the development of serious venture capital pools within this country, appropriate tax policy must embrace professional investors in this class, and not just smaller individual players.

A capital gains reinvestment system comparable to the U.S. would dramatically improve the market for early stage funding in Canada. Specifically, we recommend the following changes:

- Eligible investments should be defined as Canadian based companies with assets of no more than CAN$75 million (equivalent to U.S. level in US$);
- No limit to the size of financing and hence post-investment value of assets in the company;
- No limit to how large the company can grow;
- No limit to the number of times a rollover can be transacted, provided eligible investments are found; and
- No limitation as to type of investor (individual, trust, limited partnership, corporation, etc.).

The above characteristics reflect and expand upon the rollover provisions in existence in the U.S. and provide an additional incentive to investors willing to take the risks of early stage investing. This policy would have a significant impact on Canadian venture capital firms, which professionally manage high-risk investment funds on behalf of individuals, corporations, trusts, etc. through limited partnership structures. The size of eligible company – up to $75 million – reflects the fact that successful technology companies in the U.S and Canada are increasingly requiring larger amounts of capital at very early stages. As well, the amount of funding required to achieve success is increasing dramatically. This is due to the speed at which technology companies must grow if they are to achieve market success on a global scale.

It is worth noting that this type of rollover provision will only result in a deferral and not any loss of tax revenue. In fact, these measures will likely have the effect of much greater overall tax revenues in the future as far more productive growth will result and many more tax generating opportunities will be created.

Reduced Capital Gains Rate to Incent Companies to Become Publicly Traded

The Capital Markets Team supports the analysis recently conducted by the CD Howe Institute indicating that the tax regime in Canada has provided support to small businesses to grow. These incentives are in the form of lower taxes on the first $300,000 of income earned by CCPCs from an active business carried on in Canada, the lifetime capital gains exemption of $500,000 and the benefits surrounding research and development expenditures. However, less incentive exists to motivate companies to grow into very large companies. These incentives for small businesses, in a perverse way, also act as a disincentive for small and mid-sized companies to become major global competitors. In fact, studies also indicate that Canadian venture capital funds dispose of their holdings through private sales and management buyouts and resort to fewer public offerings than U.S. venture companies. Companies in the category of world players are typically publicly traded, as they require larger amounts of capital and credibility, which only the public markets can provide.

We recommend introducing tax provisions similar to those available in the U.S., which reduce the amount of capital gains tax paid by 50% on shares of qualifying small business companies which have transacted initial public offerings, so long as investors hold the shares for a minimum of five years. The obvious intent behind this change is to incent companies to go to the next stage of financial success. Public companies, in general, are the best positioned to continue to grow through acquisitions as opposed to being acquired which is so often the exit strategy pursued by successful, albeit small, Canadian companies.

Lower Personal Income Tax Levels

Canadian personal income tax levels are one of the highest among the G7 countries and much higher compared to the U.S. Maximum rates of personal taxation start at CAN$60,000 to $70,000 while, in the U.S, the highest tax bracket starts at approximately CAN$400,000. Talented and ambitious Canadians have a great incentive to migrate to the U.S. and many of them do so.

The Capital Markets Committee advocates reform and reductions in the overall levels of personal tax, which allow Canadians at all levels of income to achieve after-tax levels of income at least as attractive as those available in the U.S. This can be achieved through a combination of increasing the tax bracket thresholds and reducing the applicable tax rates. Although steps were taken to reduce the 5% deficit reduction tax over several years in the past budget, the Capital Markets Committee advocates an immediate withdrawal of this tax.

More Favourable Tax Treatment for Foreign Investors

The U.S. has for many years pursued a policy of not taxing any foreign investors on capital gains generated in the U.S. This policy, and the more favourable capital gains tax treatment available to individuals, are widely believed to be the two most important factors behind the formation of the world's largest pool of risk capital and dynamic growth of entrepreneurial companies in the U.S.

This view is also supported by the Israeli experience. For many years, Israel received limited foreign investment due to its restrictive tax policies, which taxed foreign investors on capital

gains. The Israeli Monetary Authority addressed this issue by granting special rulings to foreign investors and investment fund managers directly for specific investors stating that any capital gains generated by foreign investors in Israel would be tax-free. This very simple approach provided for enormous growth in the amount of foreign capital flowing into Israel. Today, Israel receives far more venture capital from foreign investors and annually lists more publicly traded companies on NASDAQ than Canada. Foreign investors clearly view Israel as a more favourable country in which to invest.

Until recently, venture capital fund managers in Canada were completely precluded from raising money offshore and, in particular, from the U.S. Notwithstanding the treaty provisions, these U.S investors were typically viewed as carrying on business in Canada despite the fact that the investment was made through a limited partnership structure managed by a Canadian fund manager. Recent administrative policy changes in Canada have attempted to address this problem. However, these administrative changes do not provide sufficient certainty to a foreign investor that no tax will be paid. Many of these foreign investors are extremely cautious pension and endowment funds bound by fiduciary obligations in their own governing structures and will avoid investments where there is any foreign tax risk. For this reason, we recommend the adoption of a general tax exemption for capital gains generated by foreign investors in Canada.

It should be noted that this would not be lost revenue to Canadian tax authorities since these are new investors bringing new capital. In fact, it will lead to the growth of additional tax paying corporations and corresponding growth in aggregate tax revenues. If this approach is not possible, the Canada Customs and Revenue Agency should adopt the Israeli model of providing tax rulings on an expedited basis to give these foreign investors the certainty they require: specifically, that no tax will be paid on investments made through Canadian venture capital funds.

Efficient Tax Treatment for Cross-Border Share-for-Share Mergers

It is very common for growing technology companies to enter new markets and acquire new customers, employees, technologies and strategies through a merger with a complimentary business or even a competitor. Many early stage technology companies routinely complete several mergers and/or acquisitions prior to achieving maturity as a successful business and generating any returns for their investors. Since the U.S. market is so large, and has such a dominant global presence in the technology industry, Canadian companies frequently seek to complete cross-border mergers with U.S. companies as part of their normal pattern of growth and development.

For a variety of business reasons, including the fact that early stage companies simply do not have excess cash for acquisitions, the overwhelming majority of these mergers is completed through a share exchange structure and not as a cash purchase. The company's shareholders receive shares in the combined company and no investor receives cash proceeds in these transactions, since the risk-taking business venture has not yet achieved success, but is continuing.

When Canadian investors hold shares in Canadian companies which merge with other Canadian companies in this way, the investor receives a rollover such that no cash tax is payable until the investor actually receives cash proceeds for his investment. Similarly, when Canadian investors hold shares in non-Canadian companies, which merge with other non-Canadian companies, rollover treatment is also available. However, when a Canadian company completes a merger with a non-Canadian company – a typical cross-border transaction – no such rollover is available. Canadian tax laws impose a cash tax obligation on Canadian investors who receive no cash, only high-risk illiquid shares in private companies, in these transactions.

Since successful mergers and acquisitions are a key element of the success of many growing technology companies, this gap in Canadian tax law creates significant problems for many of them. Professional tax and legal advisors in Canada have created complex transaction structures designed to address this problem through the creation of so-called Canadian exchangeable shares. While these structures avoid the immediate tax problem, they create consequential problems under U.S. securities and tax laws, and they are needlessly time-consuming and expensive. In many cases, the original Canadian investors in the merged company end up with reduced liquidity for their investment relative to their U.S. counterparts and thereby become "second class citizens" in the company. The issue has become so severe that many Canadian entrepreneurs establish their new businesses as U.S. incorporated companies when they begin, driving capital market activity to U.S. lawyers, accountants and investment bankers and weakening Canada's financial industry.

There is no reason for Canadian companies to remain at this significant disadvantage. Canadian tax authorities do not currently receive any tax revenue from these transactions since there are no cash proceeds paid to the Canadian shareholders. Rather than impose an expensive "speed bump" on Canadians by requiring the use of the exchangeable share structure, the rollover for wholly domestic and wholly foreign mergers should simply be extended to cross-border transactions.

More Effective Treatment of CCPC Employee Share Options

Investors or founder employees must hold shares in an eligible CCPC for a period of 24 months before being able to take advantage of the lifetime $500,000 capital gains exemption. However, employees of these same companies who buy shares, through the exercise of stock options, must hold the shares for at least 24 months before they are eligible for the lifetime capital gains exemption, regardless of how long they may have held the options as employees before exercising the options. We believe there is little difference between an employee who left a secure paying job to assume the much higher risks of a private company and the owners who invested cash in the company. Both groups have assumed significant financial risk, whether through lower income in exchange for share options or the risk of corporate failure. For this reason, we recommend that the 24-month period be extended to apply to the period of time that an employee has held the options. This change would provide a further incentive to those employees willing to trade the security and often higher salaries associated with more stable forms of employment for the higher risk, higher reward opportunities of an early stage company.

A further issue exists regarding the method under which option gains are treated by tax legislation. The recent budget in February, 2000 removed the issue of tax being paid at the time an option is exercised so that tax will now only be paid when the underlying shares are sold. However, there is still an issue surrounding the tax base of the share sale. In most instances, option holders only exercise options at the time they wish to sell the shares and hence the cost base is the option purchase price. However, if, for other reasons, the shares are purchased by way of options and the shares are not immediately sold, the cost base to be used in determining the tax paid is the market price at the time of exercising. Therefore, if the shares are sold at a later point and the value of the shares has declined in the intervening period, a tax liability will be incurred based on the higher value.

We recommend amending the legislation such that the cost base for tax purposes is the option strike price regardless of when the shares are sold. If the shares are sold at a later time for a value in excess of the strike price, tax will be paid as if it is a capital gain and, if the shares are sold at a value below the strike price, then a capital loss will be incurred which can be used to offset capital gains from other dispositions.

Expand Registered Retirement Savings Plan ("RRSP") Mandate to Employee Share Option Investments

Currently, employees are allowed to purchase shares in private Canadian companies through funds held in RRSPs. However, in the event employees hold options to purchase shares, they must use funds held outside of their RRSPs.

A very powerful incentive for employees working for private companies or potential employees who are currently working for larger organizations to pursue entrepreneurial careers would be to allow these people to hold the shares received through the exercise of the options in their RRSPs. This benefit would be limited to employees of Canadian companies, which do not otherwise provide retirement pension plans. This would provide a deferral on capital gains tax paid and provide an extra incentive to offset the higher risks of early stage companies. The gains would accumulate tax-free until such time as the monies are paid out, at which point tax would be paid. The proposal has the further benefit in that it meets the Government objective of encouraging Canadians to assume responsibility for their own retirement future. As well, in the event a gain is realized, there is an incentive to keep the money in the RRSP. Further investment of these proceeds would be restricted to the normal RRSP investment rules, which restrict the percentage of investment allowed outside of Canada, thereby encouraging Canadians to reinvest in Canadian-based opportunities.

Tax Deductibility of Student Loan Principal

The most talented and technically skilled employees in Canada generally pursue higher-level education at great expense. It is not unusual for many students graduating in Canada to assume debt levels in the range of $30,000 to $40,000. Upon graduation, there is understandable pressure felt by these individuals to pay off the debt as expeditiously as possible. The higher nominal level of wages in the U.S., coupled with the lower level of personal taxation, provides a persuasive argument for seeking employment in the U.S. One policy alternative would be to provide an opportunity for these debt-laden students to pay off their debts more quickly, provided they remain in Canada.

The Capital Markets Team recommends new legislation to allow students to deduct from taxable employment income the amount of any student loan principal repayment, provided they remain employed in Canada. Proof would be required from students that loans received would be for *bona fide* educational expenses. The deduction would need to be limited to the first five years after graduation. This change would offer several advantages including the incentive for top graduates to remain in Canada for that critical initial period, during which time they will typically establish their career and their home in Canada. Furthermore, it would recycle the student loan principal more quickly as there would exist a real incentive to early repayment. This would also address some of the contentious issues existing between the banks and the Government regarding the entire student loan program as it would shorten the time loan balances are outstanding and therefore the overall size of the program. Perhaps most importantly, it would send a powerful message to the knowledge-based industries that Canada is education friendly.

OTHER INITIATIVES

The recommendations set out in this brief are limited to issues of fiscal policy normally addressed by the Ministry of Finance. The Capital Markets Team understands there are many other important policy initiatives required for Canadians to effectively compete in the new economy (in such areas as securities regulation, stock exchange rules, financial institutions and others), which are beyond the scope of this Brief.

In the event that the Department of Finance does have the ability to influence the following issues, we strongly support the following:

Security Escrow Regulations: New legislation is currently being prepared by the various provincial securities commissions to govern the ability of founder shareholders and investors to sell their shares as part of, and post, initial public offerings on Canadian stock exchanges. These regulations remain significantly more restrictive than comparable requirements of the Securities Exchange Commission ("SEC") in force on U.S. stock exchanges, including NASDAQ, the exchange of choice for the knowledge-based sectors. Any such regulations, which restrict the liquidity of trading shares on Canadian stock exchanges relative to U.S exchanges, will only serve to incent our best companies and entrepreneurs to seek stock exchange listings south of the border. As such, the Capital Markets Team endorses the recommendations put forward by the Canadian Venture Capital Association and the Investment Dealers Association, both of which are calling for legislation no less restrictive than that available to companies listed on NASDAQ.

National Securities Commission: Much discussion has taken place regarding the amalgamation of the various provincial securities commissions under one national securities commission similar to the structure of the SEC in the U.S. While the process has been streamlined in recent years, the various provincial securities regulatory authorities continue to provide for a needlessly complicated, bureaucratic and expensive process for anyone determined to sell securities on a national basis. Although we understand the political complexity surrounding such an issue, the Capital Markets Team strongly supports the

establishment of one national body to effectively and efficiently regulate securities related issues.

Private Placement Legislation: The rules regarding private placement financing are currently under review by provincial securities regulatory authorities in Canada. Current legislation was designed for a different era, and is frequently difficult for early stage technology companies and their investors to comply with from a practical standpoint. The Capital Markets Team supports revised legislation which would make it easier for entrepreneurs to raise money from qualified individual investors on the basis of a simple set of financial net worth and income tests, similar to those available in the U.S.

The Capital Markets Team plans to make more detailed recommendations with respect to these other policy challenges to the appropriate regulatory and governmental authorities as appropriate opportunities arise.

The Capital Markets Team appreciates the opportunity to submit this Brief to the House of Commons Standing Committee on Finance and would welcome additional discussions and consultations regarding any of the issues addressed above.

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Exhibit A

CANADIAN E-BUSINESS OPPORTUNITIES ROUNDTABLE

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Kathryn Beaton, Chief Information Officer, **Ontario Hydro Services Company**
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SPECIAL ADVISOR ON TAX AND PUBLIC POLICY:

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Exhibit C

CAPITAL MARKETS TEAM

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